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SUBJECT: Scenesetter for TIFA Talks

Sensitive But Unclassified -- Not for Internet.

A Quest for a Political FTA, Skipping the Hard Work  
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11. (SBU) The Trade and Investment Framework Agreement (TIFA) talks have become an important part of our overall bilateral relationship since 2004. During the third annual round of talks on March 12, the U.S. delegation will need to fend off Mongolia's efforts to get the U.S. to agree by the end of 2007 on a "roadmap" toward a bilateral Free Trade Agreement (FTA). Mongolia's argument for an FTA is entirely political: agreement on an FTA as a goal would be a public symbol of our good bilateral political relations, and serve as Mongolia's reward for its political and economic transformation since 1990 (AKA, "you did it for Jordan"). The potential economic gains to Mongolia of an FTA are dubious, given that Mongolia's exports to the U.S. are currently more than 90% textiles, and that its overall exports are dominated by minerals. Economically, Mongolia would do far better to tackle the serious barriers to increased trade and investment, particularly in the minerals sector, which the U.S. side will list during the talks.

A Flourishing Bilateral Relationship  
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12. (SBU) On January 27, Mongolia and the U.S. celebrated the 20th anniversary of the establishment of diplomatic relations. Mongolia has only two real neighbors, China and Russia. While careful to maintain good relations with both of these giants, Mongolia has successfully sought to neutralize its geographical handicap by building strong "third neighbor" relationships with other nations. The United States is the linchpin of this third neighbor policy. A July 2004 joint presidential statement coined the phrase of "comprehensive partnership" for the U.S.-Mongolia bilateral relationship. U.S.-Mongolia engagement ranges from the Community of Democracies (Mongolia is a Convening Group member) to Mongolia's emerging role with U.S. assistance as an international peacekeeping contributor, and one with boots on the ground supporting Coalition efforts in Iraq and Afghanistan.

13. (SBU) In a March 5 phone call, President Bush invited President Enkhbayar to visit the United States this year, reciprocating the highly successful visit to Ulaanbaatar by the President, First Lady, and Secretary Rice in November 2005. The dates for Enkhbayar's visit are still to be determined, but the Mongolian government recently decided Enkhbayar will represent Mongolia at the signing of a Millennium Challenge Account (MCA) Compact.

14. (SBU) Eligible for MCA assistance since May 2004, Mongolia has

been frustrated by the delay in reaching a Compact. However, matters currently look on track for a late 2007 signing. The Compact likely will include projects to enhance railroad capacity, boost vocational education, improve property rights registration, and bolster preventive medicine efforts. The \$200 million or so of projects over five years should give Mongolia a substantial economic boost -- and, as the MCA project intends, reward Mongolia for making many correct political and economic choices in the last 17 years. Amid U.S. budgetary stringencies, other U.S. assistance (through USAID and with monetized USDA wheat) has dipped in the last couple of years, but still provides important boosts to: economic policy reform and competitiveness; entrepreneurial efforts in rural and urban areas; judicial reform; anti-corruption efforts; and a more effective parliament.

#### A Weak Government, but Populism Is Popular

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15. (SBU) Mongolia's current coalition government is not particularly strong or decisive, but quite likely will stagger along until parliamentary elections in June 2008. A month rarely passes without rumors of the government's imminent collapse, and Prime Minister Enkhbold is currently busy fighting off government reorganization efforts pushed by rivals in the MPRP. The government is dominated by the MPRP, which holds a one-seat majority in parliament after picking up a seat in a by-election last September. The "Government of National Unity" currently includes two other small parties, who have a total of seven MPs as compared to the MPRP's 39. Business leaders, foreign and domestic, are still celebrating the January jettisoning from the government of mercurial and undisciplined Industry and Trade Minister Jargalsaikhan and Health Minister Gundalai; both men are the sole MPs of minor parties, and parlayed support for the MPRP bringing down the

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previous MPRP-Democratic Party coalition government into Cabinet posts in the replacement.

16. (SBU) The evenly-balanced parliament and coalition governments in the last three years have coincided with high world prices for the mineral commodities Mongolia produces. The results have been skyrocketing values for mineral exports (leading to Mongolia's first trade surplus last year), and booming government revenues (producing government surpluses two years in a row). Another result has been flourishing populism. While most of Mongolia's mineral resources remain undeveloped -- development which will need large amounts of foreign capital -- Mongolia is experiencing what some observers have termed "pre-seller's remorse." The political argument goes, "Why should foreigners profit from the mineral wealth of the Mongolian people while 35% of Mongolians remain poor?"

17. (SBU) The results in 2005 were an abruptly-enacted confiscatory Windfall Profits Tax on copper and gold, and extensive amendments to the Minerals Law which created a much worse regulatory environment and -- in a massive step back from progressive privatization since 1990 -- gave the state the right to take equity stakes in mines on "strategic deposits." Politicians immediately competed to distribute revenues raised from the Windfall Profits Tax to voters through cash stipends for children and payments to newlyweds, and to vote for major increases in non-competitively tendered infrastructure projects. In the first negotiation under the new minerals law, meanwhile, the government is demanding a 34% stake without any payment or need to contribute to the \$1 billion in additional investments to produce a working mine. Negotiations are stalled. To the government and parliament's credit, however, major tax reforms passed last year move Mongolia considerably toward world norms, and address longstanding tax system complaints of foreign and domestic businesses.

#### Rolling Up Our Sleeves

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18. (SBU) The combination of the above will make for a busy and complex day on March 12. On the one hand, the TIFA talks will celebrate the close overall bilateral relations and the considerable, growing cooperation on trade and economic issues. On

the other hand, the U.S. side will need to explain, to the Mongolian side's disappointment, that there won't be any shortcuts in the TIFA process, much less a roadmap toward some "FTA Lite" which would skip the hard details as a nod to those close relations. Rather, Mongolia and the U.S. will need to roll up our sleeves and concentrate on addressing the trade and investment climate problems that handicap not just Mongolia's economic relations with the U.S., but also domestically and with the rest of the world. Building the road to Mongolia's economic prosperity, much less the road toward any future decisions on an FTA, necessarily will require considerable hard work to remove such barriers.

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